DIRECTORATE-GENERAL FOR EXTERNAL POLICIES
POLICY DEPARTMENT

EUROPEAN PARLIAMENT

BRIEFING

The Russian-Ukrainian gas deal: Taking the bite out of winter?

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Abstract

A recent agreement between Moscow and Kyiv, triumphantly heralded by the European Commission, is unlikely to prove everything promised by an outgoing Commission President José Manuel Barroso. Brokered by the EU, the deal should preclude a repeat of the winter gas crisis that hit Ukraine and the EU in 2006 and 2009. Already, Russia – which cut supplies to Ukraine in June 2014, when pro-Russian separatists were waging war in eastern Ukraine – has agreed to restore the supply in the cold months ahead. Prices and conditions have also been settled. But the plan's short-term solutions leave a number of problems unresolved. Ukraine's national reserves and the IMF will pay for some of Ukraine's gas, although a contribution from EU taxpayers cannot be ruled out. Not all of the agreement has been made public, and its sustainability is questionable: even if the deal has taken the bite out of winter, the ramifications for the following seasons are uncertain. The EU's energy security is likely to remain hostage to tensions between Kyiv and Moscow until Ukraine's structural weaknesses are repaired and the country's role as guardian of the pipelines reduced.

DG EXPO/B/PolDep/Note/2014_208 November 2014

PE 536.415 EN

This paper is an initiative of the Policy Department, DG EXPO.

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PUBLICATION:

English-language manuscript completed on 11.11.2014.

Printed inBelgium

This paper is available on the intranet site of the Directorate-General for External Policies, in the Regions and countries or Policy Areas section.

Table of contents

1 The agreement, unveiled by a proud Commission

While an agreement reached at the end of October between Ukraine and Moscow was proudly publicised by the European Commission, the deal may prove less than completely sweet.

An agreement concluded on 30 October 2014 between Kyiv and Moscow on Russia's supplies of gas to Ukraine for the upcoming winter was proudly heralded by the former European Commission President José Manuel Barroso. 'There is now no reason for people in Europe to stay cold this winter[1]', President Barroso announced. Equally triumphantly, Commission Vice-President Günther Oettinger declared that the EU, who had brokered the agreement, would 'not provid[e] any specific guarantees from the Brussels budget[2]'. The deal seemed an unambiguous win-win outcome.

But is this entirely true? Will EU taxpayers really face no bills? And what are the long-term ramifications for Russian gas transiting through Ukraine towards the EU? Is the scenario of a disruption in the Union's supply of natural gas[3] completely off the table?

In fact, the devil is in the agreement's details – and not all of these are known. Reports in the media have not addressed all the potential pitfalls in the deal, which may well prove thornier than suggested. What is more, a number of the larger issues – the outcome of the South Stream pipeline project, for example, or the long-term sustainability of the EU's supply – are far from resolved.

2 The public particulars of the deal

In June 2014, with military conflict on-going in eastern Ukraine, Russia cut Ukraine's gas for domestic consumption; Kyiv had failed to pay for previous supplies and had a significant outstanding debt. In 2013 Ukraine had consumed 45 billion cubic meters (bcm) of natural gas, 55.8 % (25.1 bcm) of which came from Russia.

After Moscow cut Ukraine's gas, the European Commission acted as a mediator, trying to find an agreement to ensure that Ukraine would have gas for the winter ahead. The alternative was not only politically unpalatable, but practically unpleasant: in 2006 and 2009, Ukraine had siphoned off the gas transiting through its territory destined for the EU market after its own gas was cut.

On 30 October 2014 Ukraine and Russia agreed to a short-term package that should ensure Ukraine receives gas this winter.

A draft agreement between Ukraine and Russia was proposed by the EU on 26 September in Berlin. The final deal was reached on 30 October following seven rounds of trilateral negotiations.

The key issues were establishing a payment schedule, a guarantee for Ukraine's gas debt, the price for gas supplies during the autumn-winter period and payment modalities (whether the gas would be pre-paid or paid

[1] See Ukraine-Russia gas deal. Cold self-interest. The Economist, 31 October 2014.
[2] See Russia and Ukraine reach gas deal, Financial Times, 30 October 2014.
[3] This scenario was described in A cold winter to come? The EU seeks alternatives to Russian gas. European Parliament, Directorate-General for external policies- Policy Department.

after delivery). Ultimately, Ukraine agreed to pay USD 3.1 billion of its debt to Russia in two instalments (one of USD 1.45 billion and one of USD 1.65 billion) by the end of the year. In return, Russia agreed to provide Ukraine with gas until the end of year at a price of USD 378 for 1 000 cubic meters, and then at USD 365 per 1 000 cubic meters until March[4]. This price was a significant reduction from the price Gazprom had requested on 4 March 2014: EUR 465 per 1 000 cubic meters. Under the agreement, prepayments for planned deliveries are to be made in advance. Moreover, the 'take or pay' clause that had been included in previous arrangements – requiring Ukraine to pay for fixed gas quantities, regardless of whether or not those quantitates were used – will not be included.

Key elements of the agreement include the timing of Kyiv's debt repayment, gas prices and the pre-payment for new supplies.

According to reports, Ukraine made its first payment of USD 1.45 billion on 4 November. But because its prepayment of USD 760 million for the country's November-December supplies had not been made, the flow had not yet resumed. While some, including Gazprom CEO Alexei Miller, assert that gas will restart this week, others – including Ukrainian Prime Minister Arseniy Yatsenyuk – are more pessimistic. Andriy Kobolev, CEO of the Ukrainian national gas and oil company Naftogaz, declared on 5 November that Russian gas would only restart 'during the period of peak demand'. Kobolev also stated that 'European companies remain the key gas suppliers this winter'[5] – in part referencing the 'reverse flow' of some EU countries (who sending the gas they receive from Russia and other sources on to Ukraine), a practice deemed illegal by Gazprom when it involves Russian gas[6].

3 Assessing the stakes and outcome

Negotiations were conducted under real pressure, with winter temperatures looming.

Negotiating the Ukrainian gas agreement was one of the final efforts of the Barroso Commission, acting as a mediator between the parties. The Commission worked to complete negotiations before the coming winter. Yet the final agreement brokered by the Commission is not entirely transparent: while the binding protocol is public, the annex is secret. As mentioned above, a key negotiating point concerned Ukraine's payment of its current debt to Gazprom and it pre-payment for new gas supplies. The distrust between the parties and the on-going war in eastern Ukraine led Moscow to ask Kyiv to pay before gas was delivered. Russian President Vladimir Putin even asked the EU to guarantee Ukraine's gas debt, as a sign of the EU's genuine commitment to the country[7].

As part of the agreement is secret, the sources of payments are not completely clear.

Yet this sort of guarantee was not an option for the Commission: EU taxpayers would not be willing to pay Ukraine's debt to Gazprom, particularly given the country's level of waste and mismanagement. Ukraine consumes nearly as much gas as Italy, whose GDP is nine times Ukraine's. Ukraine's

[4] The new price was calculated using a formula which deducts USD 100 from the original price, due to a duty decrease provided by the Russian government.
[5] See Europe to remain key gas supplier to Ukraine in winter — Naftogaz. ITAR-Tass, 5 November 2014
[6] See A cold winter to come? The EU seeks alternatives to Russian gas, mentioned.
[7] See: Putin Tells EU to Help Ukraine Pay for Winter Gas, Bloomberg, 17 October 2014

'energy intensity' – the ratio of energy used to economic output – is twice that of Russia and 10 times the OECD average[8].

The EU has said it will not have to pay for Ukraine's gas debt.

In the final phase of talks, Commissioner Oettinger declared that Ukraine would be able to pay Gazprom 'through its national budget and the cash generated by Naftogaz, its energy company'[9]. According to a senior Commission official, the first element of this assertion – Ukraine's budget contribution – was made possible by the IMF's decision to allow the country to tap into its Central Bank's reserves, which are already lower than the security threshold. Gold reserves are being used to pay the debt, before the IMF pays the second tranche of its macroeconomic assistance loan[10]. Because of this, Commission President Barroso could confirm, '(...) the International Monetary Fund (IMF) has reassured Ukraine that it can use all financial means at its disposal to pay for gas[11]'. The second source of Ukrainian funding mentioned by Oettinger – Naftogaz revenues – was dependent on Gazprom, which re-started paying the Naftogaz transit fees on 10 October – USD 152 million for transit in September and October.

The first payments will be provided by the Ukrainian Central Bank and Naftogaz...

...but EU taxpayers may well have to pay the Ukrainian gas bill sooner or later.

But rescuing Ukraine will come at a cost for the EU. Commission President Barroso has declared that 'unprecedented levels of EU aid will be disbursed in a timely manner'. His promise is quite vague: the exact figures have not been made public, and the EU continues to run the risk that it will feel compelled to pay for Ukrainian gas. While Ukrainian funds for first payment have apparently been found, it remains unclear how the second tranche of debt (USD 1.65 billion, due by the end of the year) will be paid for – or how the country can provide advanced payment for subsequent gas supplies. The USD 760 million due for advance payment reportedly available will only cover around 2 bcm, while IMF funds are unlikely to come before the beginning of 2015. It thus appears very likely that the EU will have to play the role of rescuer.

The negotiated price is significantly lower than initial Russian request and there is no limit to the volumes to be imported by Ukraine.

Yet the agreement also includes some positive elements. For one thing, the prices are substantially lower than those initially requested by Gazprom on 4 March. At that moment, immediately following the fall of Yanukovych, Gazprom had asked USD 485 per 1 000 cubic meters – 80.4 % more than the previous price. The agreement sets no quantitative limit. A number of press reports have mentioned a volume limit of 4 bcm (citing Naftogaz officials), but the published text of the agreement suggests Ukraine is in fact free to import the quantities it will need, based on winter temperatures.

[8] See Financial Times, mentioned.
[9] See Financial Times, mentioned.
[10] IMF negotiated a loan for macroeconomic assistance of USD 17.01 billion (USD 3.2 billion already paid). However, Ukraine is unlikely to receive the second tranche (equal to USD 2.7 billion) this year until a new government is in charge. See Ukraine unlikely to receive IMF loan tranche this year: finance minister. Reuters, 28 October 2014
[11] See EU Commission press release, 30 October 2014

4 Ambiguity, inefficiency and an EU headache

Dark clouds on the horizon have not dissipated.

Despite the agreement, concerns remain: gas has not yet begun flowing to Ukraine, the source of funding is not completely clear and the price agreement is only temporary. In March 2015 – or earlier – the question can be re-opened. Moreover, a decision from Stockholm's Court of arbitration on the settlement of the Ukrainian debt is expected by the end of the year: if Russia's claim prevails, the decision could increase the level of Ukraine's debt to USD 5.3 billion[12].

Ukraine is wasting gas with poor management and low energy efficiency.

The problem of Ukraine's gas is also a problem of the country's internal politics. Ukraine's energy inefficiency is the direct result of Kyiv's lack of policy. The government has made little efforts to change wasteful practices, and Ukraine's poorly-insulated buildings are over-heated. Mismanagement of Naftogaz and corruption are also significant factors. While many blame Russia for blackmailing a gas-dependent Ukraine, only a few have noted that Ukraine has used 'the transit pipeline as a bargaining chip to negotiate the price at which Ukraine would buy its gas from Russia'[13]. The IMF loan to be granted will include conditions to force a deep reform of the country's murky energy sector. In the meantime, the EU has essentially been forced to back Ukraine for reasons of political solidarity and in order to avoid disruptions in the transit of gas destined for the EU, as happened in 2006 and 2009.

Unless deep reforms are implemented, the only way for the EU to secure its supply of Russian gas in the long run is to bypass Ukraine.

Until the country's long-awaited reforms are implemented and corruption eradicated, the only reliable solution to bring Russian gas to the EU is to bypass Ukraine. This would require that pipelines circumvent the country from the south, just as the Nord Stream pipeline does from the north. But the southern project, the South Stream pipeline, was declared illegal by the Commission in the aftermath of the fall of former Ukrainian president Viktor Yanukovych[14]. The decision was formally based on inconsistencies between the project and the EU *aquis*. Political and geopolitical factors may also have played a role: the result allows Ukraine to continue collecting significant transit fees[15]. Yet the EU also remains a hostage to Russian-Ukrainian relations, which are obviously far from smooth.

Not all of Europe would be affected by a cut of Russian gas flowing through Ukraine. Unlike the situation in 2006 and 2009, gas transiting through Ukraine is today 'only' vital to southern Europe, and in particular for Slovakia, Austria, Bulgaria, Czech Republic, Italy, Romania and Serbia[16]. Countries in the north, like Germany, receive gas directly from Russia via the operational Nord Stream.

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[12] See year Kiev Expects to Receive Ruling of Stockholm Arbitration Court by End of 2015: Naftogaz, Ria Novosti, 31 October 2014.
[13] See Naftogaz Is Ukraine's Achilles' Heel, Carnegie Europe, 3 November 2014.
[14] See Delays to South Stream benefit Ukraine. European Parliament, DG External Policies, Policy Department, 16 December 2013.
[15] Ukraine received USD 3.2 billion in 2011 just from transit of Russian gas.
[16] See A cold winter to come? The EU seeks alternatives to Russian gas, mentioned.

Figure 1:
South Stream pipeline

Source: South Stream pipeline map, 2012. [Think Defence/Flickr]

Southeast EU Members States are applying pressure to complete the South Stream pipeline project to bypass Ukraine.

The policy of the new Commission is uncertain in this regard: will President Juncker pursue the same line as his predecessors? While the Commission has said flatly that the South Stream international agreements concluded by Member States with Russia are inconsistent with EU law, those Member States with an interest in South Stream have applied pressure on the Commission to lift its rejection. On 3 November, Hungary approved a law to build South Stream without the Commission's permits[17]. Last June Austria, Croatia, Greece, Hungary, Italy, Serbia and Slovenia sent a joint letter to President Barroso asking him to reconsider his opposition[18]. Yet the same month, the Commission's pressure led Bulgaria – where the project is at an advanced stage – to block its construction.

The position of the new Commission on South Stream will determine whether or not the EU's gas is held hostage by Ukrainian-Russian disputes.

The Juncker Commission has not yet made declarations about South Stream. However, greater dependency on Russia, especially for south-eastern EU countries, may contradict the mandate of Maroš Šefčovič, the Commission's Vice President for the Energy Union[19].

While trade sanctions have exacerbated Russia's difficult financial situation, the Ukrainian 'winter package' will provide some relief – USD 3.1 billion. In the east of the country, pro-Russian separatists continue their military actions, despite the official ceasefire, while Russia's gas deliveries to the EU continue smoothly, leaving Gazprom's image as a reliable partner untouched. Reductions in gas supplies have been registered in Austria, Slovakia and Poland. These countries began to supply Ukraine with Russian gas in September – a 'reverse flow' that Gazprom has said is illegal under to its contracts.

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[17] See Hungary attempts to bypass EU law on South Stream, Euractiv 3 November 2014.
[18] See Renzi leads belated effort in support of South Stream, Euractiv, 6 June 2014.
[19] See Mission Letter to Maroš Šefčovič, Vice-President for Energy Union, 15 Oct. 2014

Ukraine's 'winter package' is certainly an important achievement for the Barroso Commission. Yet the agreement's sustainability is questionable, and its short lifespan has underscored the urgency of developing viable long-term policy measures.